No. 16092

United States
COURT OF APPEALS
for the Ninth Circuit

STEVEN VOLOUDAKIS and KATHERINE VOLOUDAKIS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPELLANTS' REPLY BRIEF

Petition to Review a Decision of the Tax Court of the United States.

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Petition to Review a Decision of the Tax Court of the United States.

REPLY TO APPELLEE'S ARGUMENT IN SUPPORT OF THE JUDGMENT OF THE TAX COURT

Appellee hinges its argument in support of the Tax Court's decision that the contract executed between Sweeny (the landowner), Pacific (the "lessee") and Appellants (Ex. B-2) was not a sale of a leasehold estate, but was a sublease, upon the following propositions:

1. The terminology of two letters signed by Appel-

lant prior to the execution of the contract (Exs. N and O) indicates that a sublease was intended.

2. The terminology of the contract itself (Ex. B-2) establishes its character as that of a sublease, rather than a contract of sale.

3. The later "agreement" of April 8, 1947, did not supersede and replace the "lease" between Sweeny and Appellants of March 5, 1946, but that both documents continued in full force as subsisting contracts.

4. Pacific did not acquire the entire remaining balance of Appellants' leasehold term as provided under the earlier lease of March, 1946, and therefore the transaction was a subletting and not a sale of the leasehold estate.

5. The provision of the contract (par. 22, Ex. B-2) providing for reentry by Lessees upon condition broken, constitutes in legal effect the retention of a reversionary interest in the leasehold estate, and that such provision establishes the character of the transaction as a subletting.

6. There are no circumstances indicating or suggesting that an outright sale of the leasehold estate to Pacific was intended by the parties.

I.

Language of Preliminary Letters

It is, of course, manifest that the letters (Exs. N and O) in referring to the contemplated transaction, are couched in the terms of a lease, or sublease. However,

it should be remembered that these letters were not prepared by Appellants nor by their attorney, or any attorney. They were prepared by Pacific's real estate agent (R. 59, 60). Furthermore, it does not appear (as stated in Respondent's brief) that these letters were signed *"and sent"* to the agent. A more plausible assumption is that the agent who prepared them, took them to Appellant and secured his signature on them at that time (R. 60). It does not appear that Appellant had any legal advice at this stage of the transaction, or, indeed, at any stage of this transaction.

In any event, these preliminary negotiations must be considered as merged in the final transaction as evidenced by the contract between Appellants, Sweeny and Pacific (Ex. B-2). It is the legal effect of this final document which is controlling in this case.

II.

Language of the Contract

This contract (Ex. B-2) is an "agreement" between the landowner, Sweeny, directly with the "lessee" (NOT "sublessee") Pacific. Appellants were signatories to the contract of necessity. This contract also uses terms indicating that it is a lease, and indeed, it is a lease as between Sweeny, the owner of the property, and Pacific, the "lessee," but it does not even purport to be a lease as between Sweeny and Appellants, or a sublease as between Appellants and Pacific. Merely having Appellants join in the document as signatories did not make

them either lessees or sublessors per se any more than the joining of the lessee in the execution of the deed in *Sutliff v. C.I.R.*, 46 B.T.A. 466, made that lessee a grantor. Lessee joined in the deed as the Tax Court pointed out (R. 33) to "dispose of his leasehold interest." A similar result of eliminating an existing leasehold was accomplished in the instant case by the most usual and practicable method of having Appellants join in the new "agreement" with Pacific.

In none of the decisions cited by Appellee do we find any authority to the effect that the use of terminology in a document controls its legal effect and character. It is quite impossible to reconcile Appellee's argument on this point with the decision of this Court in the case of *Oesterreich v. C.I.R.*, 226 F.2d 798, referred to and quoted in Appellants' opening brief (pp. 22, 24).

In this connection it seems appropriate to point out that the later instrument (Ex. B-2) is not entitled "lease" as was the former one (Ex. A-1) but is called an "agreement." There is not one, single provision in it which obligates Appellants to perform any duty or service to the owner, Sweeny. Their only obligation is to deliver the premises to the new "lessee," Pacific. The usual provisions running from a lessee to a lessor specifically run from Pacific to Sweeny. For example: paragraph 10 gives to only Sweeny the usual lessor's right to inspect. Paragraph 18 reserves to only Sweeny the reversion of improvements on the property. Paragraph 19 authorizes only Sweeny to consent to a holding-over. There is no interest in the property or the leasehold estate retained by Appellants and no reversion is reserved.

III.

Two Mutually Exclusive Leases

Appellee's contention that the original lease of April, 1946 continued in full force and effect and binding upon Appellants after the execution of the later contract (Ex. B-2) is reiterated with minor variations throughout its brief as follows (p. 11):

> "No intention is shown anywhere in the record to substitute the sublessee for the taxpayers in the earlier lease so as to effect an assignment."

Or, page 16:

> "There is nothing in the record to indicate that the parties to the April 8, 1947 agreement did or intended to eliminate taxpayers and to substitute Sweeny (sic) in their place so as to effect an assignment of the 1946 lease."

Or, page 20:

> "In the instant case, the parties did not eliminate the taxpayers and substitute Sweeny (sic) in their place as an assignment, and taxpayers remained liable on their 1946 lease during its term."

There is a fundamental law of elementary physics that two objects cannot occupy the same space at the same time. It is equally true that two people cannot hold the same estate in the same property simultaneously (except, perhaps, under the legal fiction of estates by the entirety, which has no application here).

By the terms of the April 8, 1947 "agreement" Sweeny leased to Pacific the exact property previously leased to Appellants and for the full balance of the

term. This latter "agreement" does not purport, either expressly or by implication, to recognize the leasehold estate of Appellants. It does not purport, either expressly or by implication, to recognize a sublease from Appellants to Pacific. It is a direct lease from Sweeny, the property owner, to Pacific, the "lessee," and the mutual and reciprocal obligations between landlord and lessee are expressly established between Sweeny and Pacific. Even the most fundamental obligation, that of paying rent provided in the 1946 "lease" between Appellants and Sweeny was abrogated and all of the rental payments made thereafter to the landlord were paid by Pacific. The only obligation imposed upon Appellants by this latter "agreement" was that of delivering possession of their leasehold estate to Pacific.

Furthermore, the conduct of the parties throughout the balance of the term recognizes and confirms not only the relationship of landlord and tenant between Sweeny and Pacific, but also the elimination of Appellants from any interest in the property whatsoever. This conduct in and of itself manifests the intention of the parties to "substitute" Pacific as lessee for Appellants. This interpretation of the "agreement" by the parties by their actual performance of the terms of the "agreement" over a period of nine years could hardly be more conclusive.

IV.

Transfer of Entire Term

Appellee makes the surprising argument (Br. pp. 18, 19) that "there is no showing in the record that taxpayers did transfer the entire unexpired term of their original lease." Not only does the contract itself (Ex. B-2) provide in paragraph 2 (b), page 2, for regular payments, but further provides for payment of "the sum of Two thousand, two hundred sixty-six and 67/100ths Dollars ($2,266.67) per month thereafter during the term of the Voloudakis lease." In addition, there remains the irrefutable fact that Pacific did continue in possession of the property as new lessee under this agreement during the entire balance of the original lease and continued on thereafter under a new lease with Sweeny. There just can be no uncertainty, no question about it: Pacific did, in fact, get the entire balance of the entire unexpired term of the original lease and Appellee's brief (p. 8) so admits.

V.

Re-Entry of Default

It is strongly urged by Appellee that the provision in the "agreement" (paragraph XXII, Ex. B-2), providing that in the event of default by the lessee, "lessors without further notice or demand may enter upon and repossess the premises * * *" is the retention of a reversionary interest in the leasehold estate and therefore

establishes the character of the transaction as a sublease.

No authorities are cited in Appellee's brief (p. 15) on this point and no reference is made to the contrary authorities cited in Appellants' brief, which are to the effect that such a provision does not affect the character of an assignment or reserve a reversionary interest, but merely grants a chose in action in the event of breach. It might be argued with equal effect that a conditional sales contract of an automobile was not a sale but was merely a lease of an automobile, because it contained a provision for repossession of the car in the event of default.

VI.

Circumstances Indicating Intent

Appellee's assertion that there are no circumstances indicating or suggesting that a sale of Appellants' leasehold estate to Pacific was intended, that "there is nothing in form or substance to indicate that the earlier lease was being assigned to Pacific" (Br. p. 15) conveniently ignores the situation of the parties prior to the transaction in question, the legal effect of the "agreement" of April 8, 1947, and the parties course of conduct thereafter.

Attention is invited to the following undisputed facts:

1. Appellants were established in business in the leased property, had purchased additional equipment

and had made substantial changes and improvements in the building in contemplation of their use of the entire building for their business (R. 26, 61).

2. The transaction with Pacific which culminated in the "agreement" of April 8, 1947, was initiated by Pacific's real estate agent, Mr. Churchill Cook, who approached Appellants with the inquiry "So, I walked in and introduced myself to him and asked him whether he would consider selling out and getting out." (R. 58). Mr. Cook further specifically denied on cross-examination that he had asked Appellants whether they wanted "to lease or sublease" (R. 61).

3. There can certainly be no doubt as to Pacific's intentions. According to Mr. Cook's testimony (R. 58, 59) Appellants "had to vacate completely"—"entirely" —"to get out." Pacific took complete possession of the whole property and "did some very extensive remodeling," "spent a large sum of money" for its exclusive use (R. 59).

4. When the transaction with Pacific was closed, Appellants got out and stayed out. They had no further dealings with the property, no further dealings with the property owner, Sweeny, no further dealings with the lessee, Pacific, except to receive periodic payments. It was as clean and complete a severance of interest as could possibly have been accomplished. During the succeeding nine years, no question ever arose between the parties as to their relationship. So far as the property was concerned Appellants were out, completely out, finally out.

It is quite true, as counsel states and reiterates, that Appellant's testimony as to his understanding of the deal was a bit sketchy. This argument, however, is answered by this Court's decision in the *Oesterreich* case (supra), wherein the Court said, as quoted in Appellants' Opening Brief (p. 24):

> "However, the test should not be what the parties call the transaction, nor even what they mistakenly believe to be the name of such transaction. What the parties believe the legal effect of such transaction to be should be the criterion. If the parties entered into a transaction which they honestly believed to be a lease, but which in actuality has all the elements of a contract of sale, it is a contract of sale, and not a lease, no matter what they call it, or how they treat it on their books. We must look, therefore, to the intent of the parties in terms of what they intended to happen. (226 F. (2) 798, p. 801)"

Furthermore, Appellants are certainly not responsible and should not be penalized for any failure to develop this phase of the testimony adequately and fully. Certainly this much is clear. So far as Appellant's testimony went, it showed an intention on his part to give up and transfer his entire leasehold estate. Nothing in his testimony, even by the most tenuous implication, suggests he had in mind a sublease.

VII.

Appellee's Authorities

Consideration of the Court decisions cited by Appellee have been reserved to this portion of the brief, where they will be treated and considered together for

the following reason: none of the decisions cited in Appellee's brief are controlling authority in the following basic propositions here involved:

1. That the terminology used by the parties to a transaction either in its preliminary stages or in its final document, determine its character.

2. That the transfer, absolute transfer of an entire leasehold estate by a lessee is nevertheless a sublease.

3. That two leases of the same property, by the same owner, to different parties for the same period of time can both be valid, subsisting leases.

Strict Construction of Statute Re Capital Gain

Burnet v. Harmel, 287 U.S. 103;
Corn Products Co. v. C.I.R., 350 U.S. 46;
C.I.R. v. P. G. Lake, Inc., 356 U.S. 260.

None of these cases cited by Appellee (Br. p. 21) is authority for the asserted proposition that the capital gains provisions of the taxing statute are to be strictly construed, but only that they are not to be stretched to such an extent as to defeat the intended purpose of the law. The *Corn Products* case, citing the *Burnet* case, makes this statement:

> "But the capital-asset provisions of § 117 must not be so broadly applied as to defeat rather than further the purpose of Congress. (Citation) Congress intended that profits and losses arising from the every-day operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income."

Clearly the proceeds of the transaction here involved were not "profits arising from the every day operation of the business." It was "a transaction in property which is not the normal source of business income," to these Appellants.

The *Lake* case involved a lump sum payment received as consideration for transfer of oil payment rights and a sulphur payment right. The Court said, referring to Section 117:

> "And this exception has always been narrowly construed so as to protect the revenue against artful devices * * *.
>
> "We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income."

Clearly here there is no artful device whereby Appellants seek to substitute payments from Pacific for what would otherwise be ordinary income at some future time.

Construction Determined by Intent

Appellants certainly have no quarrel with the court decisions cited by Appellee on this phase of its argument (Br. p. 13, et seq.). Two of these decisions were cited and quoted at length in Appellants' opening brief, the other might well have been. They all seem to refute completely the superficial argument of Appellee that the character of the transaction is controlled or determined by the terminology used in the instrument.

In *Hagaard v. C.I.R.*, 241 F2d 288, a case involving

two documents: a lease and an option, the Court made the following statement:

> "The intent of the parties was perfectly plain. The bare fact that one of the joined documents was drawn in lease form and terminology by the parties *is of no consequence*. The purpose of the contracts was clear." (p. 289) (Emphasis supplied)

In *Watson v. C.I.R.*, 62 F2d 35, this Court held that a document written in the terms of a lease was, nevertheless, a conditional sales contract. The Court said:

> "It is the legal effect of the whole (document) which is to be sought for. The form of the instrument is of little account.
>
> "If we look to the legal effect of the whole transaction and not to the form, it is obvious that the instrument cannot be accepted as a lease * * *." (p. 36)

On pages 17 and 18 Appellee discusses the authorities cited in Appellants' brief to the effect that the transfer of a lease by a lessee or a cancellation or surrender of a leasehold interest is considered a sale for capital gains treatment. Appellee disposes of these authorities out of hand with the statement:

> "However, as the Tax Court pointed out (R. 32-36) those cases are clearly distinguishable from the instant case."

The Tax Court held them inapplicable expressly upon the ground that the contract before it was "couched throughout in language of a lease," and because of similar language in the preliminary correspondence (R. 34).

Under the *Oesterreich* decision of this Court, and other decisions, this language "is of no consequence."

Appellee adds the make weight that these cases are also distinguishable because they involve a lump sum payment, but not a single one of these cases indicates that the lump sum test was applied, or was material.

Presumption of Assignment

It is quite true, as Appellee argues, that the presumption of the assignment referred to in Appellants' opening brief (with authorities) is a rebuttable presumption. However, it is rebuttable not by the bare, unsupported argument or statement of counsel, but must be rebutted by affirmative evidence.

In the cited case of *Quine et ux v. Sconce,* 209 Ore. 486, the Court pointed out:

> "As a witness defendant admitted that Winter had not assigned the lease to him. * * *"

In the early decision of this Court cited by Appellee, *Northwestern Mutual Life Insurance Co. v. Security Savings & Trust Co.,* 261 F. 575, the Court states the rule as follows (p. 578):

> "We agree that as a general proposition, if one other than the lessee is in possession of premises paying rent, the law will presume that the lease of the property has been assigned to such person. On the other hand such a presumption is not irrefutable; it may be overcome *by proof* that the relationship is a different one." (Citing authorities)
>
> * * *
>
> "Privity of estate by, which one is made liable to perform covenants that run with the land, requires a transfer of the legal title by the lessee and the acceptance of it by the assignee. (Citations)"

In the instant case there was not only privity of estate but privity of contract whereby the "lessee" Pacific expressly and specifically assumed all of the obligations under the lease, including that of paying rent and that of possession.

The case of *Leh v. C.I.R.,* decided Oct. 17, 1958, which counsel quotes, involved transactions "the principal object, result and effect" (of which) "was to terminate rights, not to continue them nor to transfer them, nor sell them nor exchange them;".

And the case of *C.I.R. v. Pittston,* 252 F.2d 344, which involved a payment received for the extinguishment of contractual rights, has no application to this case where a leasehold estate was, in fact, transferred. This distinction is noted in the *Pittston* case, where the court said:

> "To be sure, the same might be said of the termination of a lessee's or life tenant's rights, but they have been distinguished as relating to matters of greater 'substance' than mere contract rights." (p. 347)

In the case of *Waller v. C.I.R.,* 40 F.2d 892, the Court affirmed a decision of the Board of Tax Appeals, which decision of the Board was based upon the conclusion that certain instruments affecting the leases which petitioners contended were subleases, constituted assignments or sales, and that consequently petitioners were not entitled to a reasonable allowance for depletion. The Court of Appeals applied the following test (p. 892):

"An assignment of a lease occurs where a lessee

parts with his entire interest in the demised premises or a part thereof for the unexpired term of the original lease. 16 R.C.L. 824, 826; 35 C.J. 988, 989. If the assignor convey less than his entire interest in the whole or a part of his lease, so that there still remains in him a reversionary interest, the transaction amounts to a sublease. * * *"

CONCLUSION

It is submitted that except for the inappropriate terminology used in the "agreement" (Ex. 2-B) for which Appellants were not responsible, and the legal connotations of which they did not understand, there could be no question but what the transaction here involved was a sale of a leasehold interest and that the consideration received by Appellants therefrom would be entitled to capital gains treatment. No authority has been presented upon this appeal to contradict the numerous decisions cited to this Court to the effect that such language is "of no consequence" in determining the true nature of the transaction.

Upon the law and the facts this Court should find and hold that the transaction in question was in fact a sale; that the proceeds received by Appellants were entitled to capital gains treatment; that the decision of the Honorable Tax Court was in error and should be reversed and the delinquency assessments vacated and set aside.

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